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TO RUCPDOG/USDOC WASHDC PRIORITY  
RUEHC/SECSTATE WASHDC 5375  
RUEATRS/DEPT OF TREASURY WASHDC  
RUEHNE/AMEMBASSY NEW DELHI 0605  
RUEHKA/AMEMBASSY DHAKA 9875  
RUEHIL/AMEMBASSY ISLAMABAD 6822  
RUEHKT/AMEMBASSY KATHMANDU 4892  
RUEHBJ/AMEMBASSY BEIJING 1217  
RUEHKO/AMEMBASSY TOKYO 2689  
RUEHRL/AMEMBASSY BERLIN 0192  
RUEHML/AMEMBASSY MANILA 1524  
RUEHUL/AMEMBASSY SEOUL 0789  
RUEHKL/AMEMBASSY KUALA LUMPUR 0318  
RUEHLO/AMEMBASSY LONDON 3520  
RUEHDE/AMCONSUL DUBAI 0112  
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SUBJECT: SRI LANKA: GROWING COUT AND APPEAL OF NON-WESTERN  
DONORS

REF A: 06 Colombo 2096, B: 06 Colombo 550

1. (SBU) Summary and comment: Sri Lanka is increasingly looking to non-Western partners like China, India, Korea, Malaysia, and even Iran to fund major infrastructure projects. These donors are promising aid without conditions, while the World Bank, Asian Development Bank, European donors and the United States are pressing the Government of Sri Lanka to seek peace, improve governance, reduce corruption, and distribute aid equitably. While much of the grant and loan money promised by the nontraditional donors may never materialize, the prospect of such unconditional money is already encouraging the GSL to question why it should listen to Western donors' advice. Newly appointed Minister of Enterprise Development and Investment Amunugama this week told the press "the pattern of development assistance is changing. We do not have to go behind the World Bank or the Asian Development Bank who are imposing conditions. As Sri Lanka taps into new sources of assistance, the Tokyo and other Western donors are at risk of losing leverage with the Rajapaksa government, making it harder for us and others to prod the government toward a peaceful solution to Sri Lanka's ethnic conflict, and address such concerns on human rights and corruption. End summary and comment.

Government Wants Infrastructure and Development...

2. (U) Sri Lankan President Mahinda Rajapaksa promised in his populist 2005 campaign manifesto "Mahinda Chintana" to deliver the benefits of development to the poor. He and his economic team believe that an intensive program of infrastructure investment will "unlock" economic potential currently dormant outside prosperous Colombo and the surrounding Western Province. However, with government

revenue insufficient to even cover the cost of Sri Lanka's vast civil service and rising defense spending, the country is dependent on donors and lenders to finance the infrastructure it wants.

... but Doesn't Want Conditionality

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¶3. (U) Rajapaksa's populist approach also features a nationalistic strain that rejects foreign influence (spurred in part by political pressure from the ultra-nationalist Janatha Vimukthi Peramuna party). Donor calls for public enterprise reform, cleaning up corruption, and restraint in the ethnic conflict are at odds with Rajapaksa's preference for big government, patronage, and seizing military advantage against the Tamil Tigers. In response, the Rajapaksa government has sought to fund its development plans without having to bend to donors' preferences. It has done this in two ways: by cultivating bilateral donors and lenders that will not impose conditions for their assistance; and by borrowing in domestic and international financial markets, rather than from the IMF.

Embraces Visitors From the East Bearing Gifts

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¶4. (U) Most of the new donors and lenders are Asian, with China in the forefront. They typically accompany high-level bilateral visits with announcements of financing for major infrastructure projects. Press reports in the last year show how lavish the Asian donors' promises are. China

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has announced more than \$1 billion, India \$450 million, Malaysia \$300 million, and South Korea an estimated \$300 million. The Asian Development Bank is also offering a generous \$450 million. Japan also remains a large donor, with over a billion dollars in its pipeline. By contrast, the United States is considering granting around \$200 million (through the Millennium Challenge Account), the World Bank plans to lend \$160 million, Germany \$150 million, Sweden \$76 million, and France \$37 million. (Note: these dollar figures are very rough, as press reports and donor announcements both tend to be imprecise.)

¶5. (U) Like China, Iran is also drawing headlines with big promises. This week, it promised \$500 million, including a \$200 million gas power plant. In making this announcement, Iranian Ambassador Behnam Behrooz explicitly stated that the Iranian government would be providing funds to Sri Lanka on an unconditional basis.

¶6. (U) The Asian donors' preference for large infrastructure projects fits well with Rajapaksa's desire to attract infrastructure projects, whereas traditional donors' insistence on stringent environmental and social impact assessments makes them wary of funding large infrastructure. More principled donors also suspect that the new donors are more tolerant of corruption in the course of these big-ticket projects.

¶7. (U) Newly-appointed Minister of Enterprise Development and Investment Promotion Amunugama this week spoke frankly to the press about the changing aid picture: "Our development partners in the forefront now are Japan, China, India, Eastern European countries such as Hungary, and the European Union. The pattern of development assistance is changing. We do not have to go behind the World Bank or the Asian Development Bank who are imposing conditions."

No Conditionality in the Bond Market Either

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¶8. (U) Ref A reported that Sri Lanka has also sought to avoid conditionality by borrowing domestically and in

international capital markets. This borrowing has amounted to over \$1.2 billion, or about 4 percent of Sri Lanka's outstanding debt. Sri Lanka began to use this avenue of debt finance in 2004 after abandoning its IMF structural adjustment program in 2003, which had called for politically difficult reform of large and powerful state-owned enterprises like the Ceylon Electricity Board. At the end of January 2007, the IMF closed its office in Sri Lanka, as it could no longer justify maintaining an office in a small country not on a program (Ref B).

Comment

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19. (SBU) We are skeptical that the giant packages like those promised by China and Iran will fully materialize, but they nevertheless have the effect of emboldening Sri Lanka to ignore the advice offered or conditions sought by traditional donors. This is a significant shift away from the incentives formulated in the 2003 Tokyo Donors Conference, which were designed in part to induce the government to pursue a peaceful resolution to the ethnic conflict. The new donors' no-strings generosity may be convincing President Rajapaksa that he can have both his war and his infrastructure, instead of having to choose between the two.

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